Current Developments

By Toussaint Tyson, Sean Barnett, and Charles Barrett

Current Developments

By Toussaint Tyson, Sean Barnett, and Charles Barrett

Overview

Purpose This article is intended to update the reader on some of the more consequential matters affecting exempt organizations.

In This Article This article contains the following topics:

Announcements and Information Releases

Ann. 2002-47, 2002-18 I.R.B. 844

Requesting comments on Chapter 42 taxes

This announcement solicits comments addressing whether regulations interpreting the Chapter 42 provisions should be revised with respect to excise taxes imposed on foundation and organization managers to conform to the final regulations under IRC 4958.

- The announcement inquires as to whether conforming revisions to the rules contained in the IRC 4958 regulations are appropriate or advisable in the case of certain Chapter 42 regulations.

Ann. 2002-27, 2002-11 I.R.B. 629

Requesting comments on electronic filing of EO Returns

This announcement solicits comments in connection with the Service's development of an electronic filing system for tax-exempt organizations' returns.

- The announcement requests comments on factors to be considered in developing an electronic filing system, including which Form 990 series should be introduced, and what factors or concerns would encourage or discourage exempt organizations to file electronically.

IR-2002-57 (May 2, 2002)

refers to Notice 2002-34, infra.

In this information release, the Service announced an opportunity for certain tax-exempt political organizations to file required forms by July 15, 2002.

- The information release notes that the voluntary compliance program for political organizations that failed to file or filed incorrectly will promote maximum disclosure to the public before the upcoming general elections.

- The information release refers to an announcement outlined in Notice 2002-34, which is an attempt to clarify filing requirements by certain political organizations.

    - The information release states that the announcement also is part of a broader effort to raise awareness about the disclosure law, and that failure to meet the filing requirements by July 15, 2002, could result in the assessment of taxes, penalties and interest.

Continued on next page

Announcements and Information Releases, Continued

IR-2001-91 (Oct. 2, 2001)

This information release announces that new tax-exempt charitable organizations formed to help victims of the September 11 terrorist attacks are posted on the IRS website.

- The new list can be found on www.irs.gov/bus_info/eo/sep11.html.
- A searchable electronic version of this list is available on the IRS website at www.irs.gov/bus_info/eo/eosearch.html.

For further discussion, see the 2003 CPE topic "Disaster Relief – Current Developments."

Notices, Revenue Procedures and Revenue Rulings

Notice 2002-34, 2002-21 I.R.B. 990

Announces a voluntary compliance program concerning IRC 527 organizations.

See also, IR-2002-57.

This notice announces a voluntary compliance program initiated by the Service.

- The notice provides that the Service will not assert any tax, penalty or interest that arises solely because a political organization failed to file a form or filed an incorrect form, if the form is filed or corrected by July 15, 2002. This voluntary compliance program applies with respect to the following forms:
  - Any Form 8871, *Political Organization Notice of 527 Status,* due on or before July 15, 2002;
  - Any Form 8872, *Report of Contributions and Expenditures*, due on or before July 15, 2002;
  - Any Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations,* due on or before July 15, 2002, including any applicable extensions; and
  - Any Form 990, *Return of Organization Exempt from Income Tax,* or Form 990-EZ, *Short Form Return of Organization Exempt from Income Tax,* due on or before July 15, 2002, including any applicable extensions.
- The notice provides that if a political organization does not completely report its contributions and expenditures on all applicable Forms 8872 filed by July 15, 2002, it remains liable for the amount due under IRC 527(j)(1) on the unreported amounts.
- The notice states that for any form described above that is filed or corrected after July 15, 2002, any applicable taxes, penalties and interest will be due from the original due date.
- In addition, the notice advises that this voluntary compliance program does not apply to any Form 1120-POL required to be filed under rules in effect before July 1, 2000, and so a political organization remains liable for the tax on its investment income due under IRC 527(b).

Continued on next page

Notices, Revenue Procedures and Revenue Rulings, Continued

Notice 2001-81, 2001-52 I.R.B. 617

Exempt Organizations Section 529 Programs

This notice provides guidance regarding certain recordkeeping, reporting, and other requirements applicable to qualified tuition programs described in IRC 529, in light of certain amendments made to IRC 529 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16, 115 Stat. 38) (EGTRRA).

Notice 2001-81 addresses the following subjects:

- Imposition of a penalty and verification of purpose of a distribution;
- Reporting of distributions; and
- Calculation of earnings

Notice 2002-10, 2002-6 I.R.B. 490

Bonds and the debt-financing rules

This notice clarifies the application of IRC 145(a)(2) and 514 to the investment of gross proceeds of qualified 501(c)(3) bonds described in IRC 145.

- The use of gross proceeds of an issue of qualified 501(c)(3) bonds to acquire investments in a manner that complies with IRC 148 does not constitute an unrelated trade or business for purposes of IRC 145(a)(2) and does not result in income from debt-financed property under IRC 514.

Rev. Proc. 2002-4, 2002-1 I.R.B. 127

TE/GE Ruling Procedures Revised

This Rev. Proc. updates procedures for obtaining guidance on issues under the jurisdiction of TE/GE.

- Such guidance may take the form of letter rulings, closing agreements, information letters, and similar letters.
- The Rev. Proc. includes provisions necessary to implement relevant sections of the Economic Growth and Tax Relief Reconciliation Act of 2001.

Continued on next page

Notices, Revenue Procedures and Revenue Rulings, Continued

Rev. Proc. 2002-5, 2002-1 I.R.B. 173

TE/GE Tech. Advice Procedures Revised

This Rev. Proc. updates procedures on how technical advice is provided to Area Offices and Appeals Offices on issues within the jurisdiction of TE/GE.

Rev. Proc. 2002-8, 2002-1 I.R.B. 252

TE/GE User Fee Procedures Revised

This Rev. Proc. provides guidance for complying with the user fee program of the IRS as it pertains to matters within the jurisdiction of TE/GE. This table lists some exempt organization matters and the applicable user fee:

ISSUE	FEE
Accounting period and method changes	$150
Application for recognition of exemption	$500
Exemption applications – reduced fee	$150
Most letter rulings	$2,470
Letter rulings – reduced fee	$600

Rev. Proc. 2001-53, 2001-47 I.R.B. 506

Time Sensitive Acts

This Rev. Proc. provides a list of time-sensitive acts, the performance of which may be postponed under IRC 7508 (concerning individuals serving in the Armed Forces or serving in support of such Armed Forces in a **combat zone**), and IRC 7508A (concerning taxpayers affected by a **Presidentially declared disaster**). The time sensitive acts applicable to exempt organizations include:

- IRC 529(c)(3)(C)(i) – 60-day rollover contribution to another IRC 529 program and
- IRC 505(c)(1) – an organization claiming exemption under IRC 501(c)(9) or (17) must file Form 1024 within 15 months from the end of the month in which it was organized.

Continued on next page

Notices, Revenue Procedures and Revenue Rulings, Continued

Rev. Proc. 2001-53, 2001-47 I.R.B. 506, continued

- IRC 508 and Reg. 1.508-1 – an organization claiming exemption under IRC 501(c)(3) must file Form 1023 within 15 months from the end of the month in which it was organized.

- IRC 6072(e) and Reg. 1.6033-2(e) – annual returns of organizations exempt under IRC 501(a) must be filed on or before the 15th day of the 5th month following the close of the taxable year.

Rev. Proc. 2001-59, 2001-52 I.R.B. 623

Indexation of various amounts

This Rev. Proc. sets inflation adjustments for tax years beginning in 2002. The items most relevant to exempt organizations are:

- IRC 512(d)(1) - the limitation for annual dues to an agricultural or horticultural organization described in IRC 501(c)(5) is $120;

- IRC 513(h)(2) - the unrelated business income of certain exempt organizations does not include a "low cost article" of $7.90 or less;

- Other insubstantial benefits – the guidelines contained in Rev. Proc. 90-12, 1990-1 C.B. 471, for disregarding the value of insubstantial benefits received by a donor in return for a fully deductible charitable contribution under IRC 170 have been updated accordingly. Rev. Proc. 90-12 Guidelines – inflation adjusted safe harbor has been changed from $5 to $7.90; $25 to $39.50, and $50 to $79.00; and

- Reporting exception for certain exempt organizations with nondeductible lobbying expenditures - for tax years beginning in 2002, the annual per-person, family, or entity dues limitation to qualify for the reporting exception under IRC 6033(e)(3) (and section 5.05 of Rev. Proc. 98-19, 1998-1 C.B. 547), regarding certain exempt organizations with nondeductible lobbying expenditures, is $83 or less.

Final Regulations

T.D. 8978, 67 Fed. Reg. 3076 (Jan. 23, 2002)

This Treasury Decision transmits the final IRC 4958 regulations, which provide:

- Precedential guidance for exempt organizations and certain persons, who are considered disqualified persons under the statute and
- Guidance on the procedure used to obtain the so-called rebuttable presumption of reasonableness. This procedure can be used by disqualified persons to obtain a rebuttable presumption that compensation arrangements or property transactions were conducted at fair market value.

For further discussion, see the 2003 CPE Topic "Update on IRC 4958."

T.D. 8991, 67 Fed. Reg. 20,443 (April 25, 2002)

This Treasury Decision transmits the final regulations relating to the tax treatment of corporate sponsorship payments received by tax-exempt organizations. The regulations are effective April 25, 2002, and are applicable for payments solicited or received after December 31, 1997.

Introduction

The final regulations replace proposed regulations that were first published in the Federal Register on January 22, 1993, and then reproposed on March 1, 2000. Thus, the final regulations culminate a process that began almost ten years ago. At each step along the way, close attention was paid to the comments of those representing exempt organizations, and their suggestions were seriously considered.

The final regulations clearly reflect attempts to address the concerns of exempt organizations and the public in a manner consistent with the rules under IRC 513(i) and the accompanying legislative history. At the same time, the final regulations provide guidance on emerging issues such as exclusivity arrangements and the Internet. There are two examples addressing Internet issues and one addressing exclusivity arrangements.

Continued on next page

Final Regulations, Continued

1993 Proposed Regulations

The 1993 proposed regulations on corporate sponsorship distinguished advertising, which is an unrelated trade or business, from an acknowledgment, which is mere recognition of a sponsor's payment and which is not an unrelated trade or business.

- The 1993 proposed regulations contained a so-called "tainting rule," which provided that with respect to a sponsorship payment, if any part of the activities, messages or programming constituted advertising, then all such activities, messages and programming would be considered advertising. The 1993 proposed regulations also contained an example of how expenses should be allocated in cases involving corporate sponsorship payments.

A public hearing on the 1993 proposed regulations was held that year, and comments from the public were received and considered.

Taxpayer Relief Act of 1997

In 1997, Congress enacted IRC 513(i), which is closely modeled after the 1993 proposed regulations. IRC 513(i) provides that certain "qualified sponsorship payments" are not subject to the unrelated business income tax.

- IRC 513(i) defines such qualified sponsorship payments as any payment made by a person engaged in a trade or business with respect to which there is no arrangement or expectation that the sponsor will receive any substantial return benefit. Like the 1993 proposed regulations, IRC 513(i) clarifies that a substantial return benefit does not encompass the use or acknowledgment of the name or logo (or product lines) of the sponsor's trade or business in connection with the activities of the exempt organization that receives the payment.

- IRC 513(i) specifically states that a use or acknowledgment does not include advertising and adopts an approach that is similar to the 1993 proposed regulations. However, unlike the tainting rule contained in the 1993 proposed regulations, IRC 513(i)(3) provides for an allocation of portions of a single payment that if made by itself would constitute a qualified sponsorship payment.

- IRC 513(i) applies to payments solicited or received after December 31,1997, and does not apply to convention and trade show activities or periodical advertising.

Continued on next page

Final Regulations, Continued

2000 Proposed Regulations

Following the enactment of IRC 513(i), new proposed regulations were published on March 1, 2000. The 2000 proposed regulations reflect the differences between the 1993 proposed regulations and IRC 513(i), and address new issues such as exclusivity arrangements.

- A public hearing on the 2000 proposed regulations was held that year, and comments from the public were received. Following extensive consideration and analysis of the comments, final regulations were published, as noted above.

Common Concepts

IRC 513(i), the two sets of proposed regulations and the final regulations all contain some differences and some similarities. What has remained unchanged since 1993 is the fundamental distinction between advertising and acknowledgments. The following is a summary of the basic principles contained initially in the 1993 proposed regulations and carried forward to the final regulations:

Acknowledg-ments

Acknowledgments do not include advertising, but may include logos and slogans that do not contain comparative or qualitative descriptions of the sponsor's products, services, or company.

- Acknowledgments may also include a list of the sponsor's locations and telephone numbers, value neutral descriptions, including displays or visual depictions of the sponsor's product-line or services, and the sponsor's brand or trade names and product or service listings.

- In addition, logos or slogans that are an established part of the sponsor's identity fall within the category of acknowledgments.

Advertising

Advertising means any message or other programming material which is broadcast or otherwise transmitted, published, displayed or distributed, and which promotes or markets any trade or business, or any service, facility or product. Advertising includes messages containing qualitative or comparative language, price information or other indications of savings or value, an endorsement or an inducement to purchase, sell or use any company, service, facility or product.

Continued on next page

Final Regulations, Continued

Written Contracts

The existence of a written sponsorship agreement does not, in itself, cause a payment to fail to be a qualified sponsorship payment.

Contingent Payments

A qualified sponsorship payment may not be contingent upon the level of attendance at an event, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity. However, a payment may be contingent on an event taking place.

Substantial Return Benefit

At the heart of the corporate sponsorship regulations is the concept of a substantial return benefit.

- The 2000 proposed regulations defined the term *substantial return benefit* as benefit other than a use or acknowledgment of the sponsor's name or logo, or certain goods or services that have an insubstantial value. The latter concept was defined in the 2000 proposed regulations as a fair market value of not more than 2% of the payment, or $74, adjusted for inflation, whichever is less. In defining the concept of insubstantial value, the 2000 proposed regulations borrowed liberally from the charitable contribution rules, which contain similar standards for individual contributions.

    - Many comments were received regarding the concept of an insubstantial benefit, and most expressed an opinion that the $74 ceiling (adjusted for inflation) was too low. The Preamble notes that IRS and Treasury agree that this ceiling, while appropriate for individuals, is too low for corporations and individuals engaged in a trade or business. The final regulations eliminate the $74 ceiling (adjusted for inflation) and simply provide that benefits are disregarded if the aggregate fair market value of all the benefits provided by the exempt organization to the corporate sponsor is not more than 2% of the amount of the payment. The final regulations state that if the aggregate fair market value of the benefits exceeds 2% of the payment, then the entire fair market value of such benefits is a substantial return benefit.

The final regulations define benefits as including advertising, exclusive provider arrangements, goods, facilities, services, or other privileges, and the right to use an intangible asset.

Continued on next page

Final Regulations, Continued

Allocation of Payment

Probably the most significant difference between the 1993 proposed regulations and IRC 513(i) is the requirement under IRC 513(i)(3) that an allocation be made in connection with portions of a single payment.

- The final regulations provide that in cases where the corporate sponsor receives a substantial return benefit, only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. If the exempt organization fails to show that the payment exceeds the fair market value of any substantial return benefit, then no part of the payment meets the safe harbor under IRC 513(i), and it does not qualify as a sponsorship payment.

- The final regulations define the term *fair market value* of a substantial return benefit as the price at which the benefit would be provided between a willing recipient and a willing provider of the benefit. The final regulations also provide that the fair market value of a substantial return benefit is determined when the benefit is provided. However, a special rule applies when an exempt organization and a corporate sponsor enter into a binding, written contract. Under these circumstances, the valuation date is the date the parties enter into the sponsorship contract. A material change to the contract will result in a new contract as of the date of such change.

Expense Allocation

The 1993 proposed regulations contained an example of an allocation of expenses under Reg. 1.512(a)-1(d), which concerns the exploitation of exempt activities. The 1993 example would have permitted an exempt organization to apply excess expenses directly connected with the conduct of an exempt activity (such as the conduct of a bowl game) to offset income from a separate, unrelated business activity (such as the sale of clothing featuring the name and logo of the bowl game).

- The Preamble to the 2000 proposed regulations stated that IRS and Treasury agree that the 1993 example was too broadly stated. The 2000 proposed regulations set forth a new example involving the sale of advertising in a museum's exhibition catalog. The new example made clear that Reg. 1.512(a)-1(d) applies only in circumstances in which the unrelated business activity and the exempt activity are closely connected.

The final regulations reiterate the position of the 2000 proposed regulations and adopt the new example in toto.

Continued on next page

Final Regulations, Continued

Treatment of Payments as Public Support

The 2000 proposed regulations provided that, for purposes of determining public support under IRC 170(b)(1)(A)(vi) and 509(a)(2), qualified sponsorship payments in the form of money or property (but not services) are treated as contributions.

- The final regulations adopt the same approach taken in the 2000 proposed regulations and add two illustrative examples. Taken together, the two examples highlight the distinction between money and property, which are included as public support, and services, which are not so included.

Exclusivity Arrangements

The treatment of exclusivity arrangements is one issue addressed in the 2000 proposed regulations that was not part of the 1993 proposed regulations, or IRC 513(i).

- The 2000 proposed regulations stated that the right to be the only sponsor of an activity, or the only sponsor representing a particular trade, business, or industry is generally not a substantial return benefit. On the other hand, a substantial return benefit will be present if the sponsor is the exclusive provider of products, services, or facilities. Thus, the 2000 proposed regulations created a distinction between situations in which there is an exclusive sponsor (not resulting in a substantial return benefit) and an exclusive provider (resulting in a substantial return benefit).

- More comments were received on the issue of exclusive provider arrangements than on any other issue raised in the 2000 proposed regulations. In summary, the commentators suggested that the 2000 proposed regulations create an implication that exclusive provider contracts are automatically subject to tax because they do not meet the requirements under IRC 513(i). In fact, IRC 513(i) establishes a safe harbor for corporate sponsorship agreements. If the requirements under IRC 513(i) were not met (such as in the case of an exclusive provider), this arrangement would be tested in accordance with the general rules for unrelated business income under IRC 511 – 514.

The final regulations adopt the same approach taken in the 2000 proposed regulations and maintain the distinction between an exclusive sponsor and an exclusive provider. However, to minimize any possibility of misinterpretation, the Preamble to the final regulations provides a number of examples of situations involving exclusive provider arrangements and applies the general rules under IRC 511 - 514.

Continued on next page

Final Regulations, Continued

The Internet

In the Preamble to the 2000 proposed regulations, it was noted that the regulations did not specifically address the Internet activities of exempt organizations, but comments were requested on the rules governing periodicals and trade shows. Comments were also requested on whether providing a link (commonly referred to as a hyperlink) to a sponsor's Internet site is advertising for purposes of IRC 513(i)(2)(A).

- The Preamble to the final regulations states that many options for addressing the Internet were considered. Ultimately, no additional guidance was provided with respect to trade shows, however, two examples were added to illustrate the issue of hyperlinks.

- The first example describes an exempt orchestra whose website contains a list of its sponsors and includes the sponsor's name and Internet address. The Internet address of the sponsor appears as a hyperlink from the orchestra's website to the sponsor's website. The example concludes that posting the sponsor's name and Internet address on the orchestra's website constitutes an acknowledgment of the sponsorship.

- The second Internet example describes an exempt organization's website that provides a hyperlink to a sponsor's website. The sponsor's website contains an endorsement of the sponsor by the exempt organization, which reviewed the endorsement and gave permission for the endorsement to appear. The example concludes that the endorsement is advertising.

- Also, with regard to periodical advertising, the final regulations provide that the term *periodical* includes material that is published electronically.

Court Cases

IRC 170

Sklar v. Commissioner, 282 F.3rd 610 (9th Cir. 2002)

The Ninth Circuit affirmed the District Court opinion that the taxpayers' tuition payments are non-deductible personal expenses and that no portion of tuition is deductible under IRC 170.

- The taxpayers made tuition payments to their children's religious schools and sought to deduct 55% of such payments on the grounds that in return for this proportion of the tuition, they received solely intangible religious benefits. They also argued that IRS permits similar deductions to members of the Church of Scientology, and there is a resulting administrative inconsistency (and First Amendment violation) in denying Orthodox Jews this very similar deduction.

- The Ninth Circuit, relying on Hernandez v. Commissioner, 490 U.S. 680 (1989), held that IRC 170 does not authorize a charitable deduction under the facts presented. The court also said that the Omnibus Budget Reconciliation Act of 1993, P.L. No. 103-66, 107 Stat. 312 (OBRA 93), which enacted IRC 170(f)(8) and 6115 does not affect the Hernandez conclusion – the taxpayers' contrary arguments notwithstanding.

- The taxpayers' "similarly situated" argument required the court to consider whether closing agreements are disclosable. The court ruled that IRC 6103(b)(2)(D), which prohibits disclosure of closing agreements, is trumped in certain cases by IRC 6104(a), which requires the disclosure of the exemption application and supporting documentation.

- The taxpayers also argued that their tuition payments are similar to a Scientologist's 'auditing' or 'training' payments, and accordingly the Service was either practicing administrative inconsistency or preferring one religion, Scientology, over another religion, Orthodox Judaism.

The court found the premise, for the administrative inconstancy argument, incorrect, because "religious education . . . [of] children does not appear to be 'auditing' and 'training' conducted by the Church of Scientology."

Continued on next page

Court Cases, Continued

IRC 170(b)(1)(A)(vi)

A district court has ruled on remand that the Fund for Anonymous Gifts (the Fund) is a private foundation and not a publicly supported organization described in IRC 170(b)(1)(A)(vi).

The Fund for Anonymous Gifts v. I.R.S., 88 AFTR2d ¶ 2001-5351 (D. D.C. 2001)

- The fund, which provides donors a vehicle for making anonymous gifts to charity, had sought a declaratory judgment that it qualified as an organization described in IRC 501(c)(3). The U.S. District Court for the District of Columbia granted the IRS summary judgment in 1997 and the fund appealed. In 1999 the D.C. Circuit ruled that after a change to the fund's charter, it qualified as an IRC 501(c)(3) organization. The court remanded the question of whether the fund was eligible to receive an advance ruling that it could reasonably be expected to qualify as a publicly supported organization. Both parties filed motions for summary judgment.

The District Court concluded that, "the administrative record does not support a reasonable expectation that the plaintiff will qualify as a publicly-supported charity." This conclusion was arrived at under either the one-third public support test of Reg. 1.170A-9(e)(2) or the ten percent/facts and circumstances test set forth in Reg. 1.170A-9(e)(3).

IRC 501(c)(3)

In three separate opinions the Tax Court addressed the qualification for recognition of exemption under IRC 501(c)(3) of three organizations that were part of The Intermountain Health System. This system was comprised of a number of organizations, including IHC Health Services, Inc., which is described in IRC 501(c)(3). Health Services' assets included 23 hospitals; and it also employed over 400 specialty and primary care physicians. This was the structure before its reorganization to take part in the federal HMO system.

IHC Health Plans, Inc. v. Commissioner T.C.M 2001-246

IHC Group, Inc. v. Commissioner T.C.M. 2001-247

IHC Care, Inc. v. Commissioner T.C.M. 2001-248

- Health Services formed IHC Health Plans and remained its sole corporate member. Health Plans became licensed to operate an HMO and to offer a variety of health plans. It had no medical facilities or physicians and never acquired either. It offered its plans to: (1) individuals and their families, (2) large and small employers, and (3) Medicaid-covered individuals. In 1985, Health Plans was recognized exempt as an organization described in IRC 501(c)(3).

Continued on next page

Court Cases, Continued

IRC 501(c)(3), continued

- Health Plans formed IHC Care and IHC Group, each of which was to qualify as a federally qualified direct contract model HMO. The two HMO's applied for recognition of exemption as organizations described in IRC 501(c)(3). The two HMO's were denied exemption under IRC 501(c)(3), and Health Plans' exemption was revoked. All three organizations petitioned the Tax Court for a declaratory judgment pursuant to IRC 7428.

In the case of Health Plans, the court held the organization had failed to show that it met the community benefit test and did not satisfy the integral part test. Similarly with regard to the two HMO's, the court found that they met neither the community benefit test nor the integral part test. The court concluded that none of the three organizations qualified for recognition of exemption under IRC 501(c)(3).

St. David's Health Care System v. U.S.
Civ. No. A-01-CA-046 JN (W.D. Tex. 2002)

St. David's was exempt as an organization described in IRC 501(c)(3) and operated an acute-care hospital in Austin, Texas. In 1996, St. David's entered into a limited partnership with HCA, Inc, a for-profit health care company. St. David's contributed all of its hospital and medical assets, and HCA contributed its hospitals and medical assets located in the Austin area. St. David's was a general and limited partner and had nearly a 46% ownership interest in the partnership. HCA entities had a 54% ownership interest.

- In 2000, St. David's exemption was revoked retroactively to the date it entered into the partnership with HCA. Revocation was based on the fact that St. David's participation in the partnership did not permit it to act exclusively for exempt purposes and allowed for greater than incidental benefits to HCA and its for-profit subsidiaries. St. David's paid tax and sought a refund, which was disallowed. St. David's then filed a refund suit.

- The District Court disagreed with the government's position and concluded that St. David's met the requirements for exemption under IRC 501(c)(3). In its opinion the court addressed whether a community board is required; whether St. David's had a community board, and whether there was private benefit to HCA. In each instance the court agreed with the organization's arguments.

For further discussion, see the 2003 CPE topic "Health Care Update."

Continued on next page

Court Cases, Continued

IRC 513

Arkansas State Police Assn. v. Commissioner, 282 F.3d 556 (8th Cir. 2002)

Arkansas State Police Association is a labor organization described in IRC 501(c)(5). The organization entered into an agreement with Brent-Wyatt West (BWW), a publishing company, to publish the organization's official publication, *The Arkansas Trooper* (the "magazine"). Pursuant to the agreement, BWW paid Taxpayer $25,200 each year to publish the magazine, as well as a percentage of the money received from the advertising published in the magazine.

- The organization treated the money received from BWW as non-taxable royalty income. The Service filed a notice of deficiency, which the organization challenged in Tax Court. The Tax Court held that amounts received by the organization from the publication of the magazine was unrelated business taxable income, because the organization participated in and maintained control over significant aspects of the magazine's publication.

- The organization appealed, arguing that payments from BWW should be considered nontaxable royalty payments because the payments are similar to those in the "affinity" credit card cases, and the services performed by the organization for BWW are all related to protecting the use of the organization's name.

- The Court of Appeals rejected the organization's arguments and upheld the decision of the Tax Court. The Court of Appeals held that the payments from BWW were not royalty income but instead were unrelated business taxable income. The court stated that the agreement between the organization and BWW was really an agency relationship and imposed a duty upon BWW to perform publishing services on the organization's behalf and under its control. To support its finding of agency, the court cited State Police Ass'n of Mass. v. Commissioner, 125 F.3d 1 (1st Cir. 1997), and National Collegiate Athletic Ass'n v. Commissioner, 92 T.C. 456 (1989), rev'd on other grounds, 914 F.2d 1417 (10th Cir. 1989).

Continued on next page

Court Cases, Continued

IRC 513

Laborers' International Union of North America v. Commissioner, T.C. Memo 2001-171

Laborer's International Union of North America (LIUNA) is a labor organization described in IRC 501(c)(5). The National Postal Mail Handlers Union (Mail Handlers) is a separate, autonomous division of LIUNA. Mail Handlers has two categories of members: regular and associate. Individuals become associate members, and pay associate member dues, in order to participate in Mail Handlers' health plan.

LIUNA's chief source of financial support is its "per capita tax" on members and affiliated unions. LIUNA levies a per capita tax on Mail Handlers based on the number of its regular and associate members. The per capita taxes are set at different rates for associate and regular members.

- The Service determined that LIUNA had unrelated business taxable income that resulted in deficiencies in its Federal income tax. The Service argued that LIUNA's collection of income from the associate membership of Mail Handlers constitutes a trade or business, and associate member dues, paid for the purpose of enrolling in Mail Handlers' health plan, is UBTI to Mail Handlers. The portion of the associate member dues forwarded to Taxpayer in the form of its per capita tax should retain its character as UBTI.

- The Tax Court rejected the Service's arguments and held that the receipt of per capita taxes calculated with reference to the number of associate members of Mail Handlers is not UBTI to LIUNA. The Court noted that the unrelated business income tax is designed to restrain unfair competition by otherwise tax-exempt organizations engaged in profit-making activities, and said that, in this case, it found no activity that competes with taxable organizations. A "per capita tax" levied by one 501(c)(5) labor union on another is not a trade or business. The "per capita tax" is not an "apportionment" of the dues received by Mail Handlers from its associate members.

    - The court also said that LIUNA does not collect any income from the associate membership of Mail Handlers. It is irrelevant that Mail Handlers collects dues from associate members that is UBTI to Mail Handlers. Other than the services LIUNA provides to its members and affiliate unions in furtherance of its exempt purposes, it provides no goods or services for profit.

Continued on next page

Court Cases, Continued

IRC 527

National Federation of Republican Assemblies, et al. v. U. S., 148 F. Supp. 2d 1273 (S.D. Ala 2001)

In this case, nine organizations and two individuals brought an action to have IRC 527(i) and (j) declared unconstitutional. Generally, IRC 527(i) requires an organization that wishes to be treated as a political organization described in IRC 527 to register with the Service. IRC 527(j) requires that such organizations disclose information pertaining to their contributions and expenditures. Failure to disclose this information results in a payment under IRC 527(j)(1)(B); whether this payment is a tax or a penalty became an issue in this case.

- After discussing the Anti-Injunction Act and the principles applicable to standing, the court concluded that the organizational plaintiffs could not challenge the constitutionality of IRC 527(i), but could challenge the constitutionality of IRC 527(j). With regard to the individual plaintiffs, the court held that one of the plaintiffs has standing to challenge IRC 527(j), while the other individual plaintiff was dismissed as a party in the case.

IRC 4958

Caracci v. Commissioner, 118 T.C. No. 25 (May 22, 2002)

Members of the Caracci family owned three home health care organizations (the Sta-Home Health Agencies) that were exempt as organizations described in IRC 501(c)(3). The family decided to convert the exempt organizations into for-profit corporations, and three for-profit entities were created under state law. An appraisal was obtained from an accounting firm stating that the value of the exempt organizations' assets was less than their liabilities. The exempt organizations transferred all their tangible and intangible assets to the for-profit corporations.

- The opinion of the Service's expert was that the fair market value of the transferred assets exceeded the assumed liabilities by $20 million. The Service determined that the three for-profit corporations, and members of the family were liable for excise tax under IRC 4958, that certain family members were liable for income taxes, and that the tax-exempt status of the exempt organizations should be revoked.

Continued on next page

Court Cases, Continued

IRC 4958,

Caracci v. Commissioner, 118 T.C. No. 25 (May 22, 2002) continued

- The Tax Court devoted most of its opinion to an analysis of the valuations, and concluded that, "the fair market value of the Sta-Home tax-exempt entities' transferred assets far exceeded the consideration paid by the Sta-Home for-profit entities." The court held that each of the disqualified persons is jointly and severally liable for the taxes under IRC 4958 with respect to the excess benefits. The court declined to abate the first-tier and second-tier taxes, while noting that IRC 4961(a) and 4963(e)(1) generally allow for the abatement of an IRC 4958 excise tax if the excess benefit transaction is corrected within the appropriate time period.

- With regard to revocation of exemption, the court indicated that with the enactment of IRC 4958, revocation must be considered in the context of the "intermediate sanction" provisions. The court stated the following: "Although the imposition of section 4958 excise taxes does not preclude revocation of the organization's tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case." The court thought that this was not such an unusual case and declined to approve revocation of exemption.

For further discussion, see the 2003 CPE topic "Update on IRC 4958."

Legislation

Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub. L. No. 107-16, 115 Stat. 38) (EGTRRA)

Among other changes to IRC 529, EGTRRA, additional changes include:

- Expanding the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions;
- Providing an exclusion from gross income for distributions from a State 529 program (and, beginning in 2004, a prepaid tuition program established and maintained by one or more eligible educational institutions) which are used to pay for qualified higher education expenses of the designated beneficiary;
- Repealing the requirement that an IRC 529 program impose a more than de minimis penalty on any refund of earnings not used for qualified higher education expenses of the beneficiary; and
    - Replacing that penalty with an additional 10-percent tax on the amount of a distribution from an IRC 529 program that is includible in gross income (with certain exceptions).

In general, these amendments are effective for taxable years beginning after December 31, 2001.

Railroad Retirement and Survivor's Improvement Act of 2002 (Pub. L. 107-90, 115 Stat. 878)

Section 202 of the Act enacts new IRC 501(c)(28) providing for the exemption from federal income tax of the National Railroad Retirement Investment Trust established under section 15(j) of the Railroad Retirement Act of 1974.

The provision is effective December 21, 2001.

Continued on next page

Legislation, Continued

S. 1924, CARE Act of 2002 February 21, 2002)

Section 105 would amend IRC 4940 to reduce the IRC 4940 excise tax rate from 2% to 1%. There would be a corresponding temporary repeal of the IRC 4940(e) excise tax reduction.

- The effective date for this provision is any tax year beginning after December 31, 2001.

Section 401 of the Act provides, via an off-Code provision, that:

- The Secretary of the Treasury or the Secretary's delegate (in this section, referred to as the 'Secretary') shall adopt procedures to expedite the consideration of applications for exempt status under IRC 501(c)(3) by any organization that -
  - Is organized and operated for the primary purpose of providing social services;
  - Is seeking a contract or grant under a Federal, State, or local program that provides funding for social services programs;
  - Establishes that, under the terms and conditions of the contract or grant program, an organization is required to obtain such exempt status before the organization is eligible to apply for a contract or grant;
  - Includes with its exemption application a copy of its completed Federal, State, or local contract or grant application; and
  - Meets such other criteria as the Secretary deems appropriate for expedited consideration.
- The Secretary may prescribe other similar circumstances in which such organizations may be entitled to expedited consideration.
- Section 401 also provides for the waiver of application fees if the organization is entitled to the expedited consideration and the organization certifies that the organization has had (or expects to have) average annual gross receipts of not more than $ 50,000 during the preceding four years (or during such organization's first four years).
- The term “social services” would be defined as described at subparagraph (A)(ii) of section 301(e)(2) of the Act; in addition, the term includes a program having the purpose of delivering educational assistance under the Elementary and Secondary Education Act of 1965 *(20 U.S.C. 6301* et seq.) or under the Higher Education Act of 1965 *(20 U.S.C. 1001* et seq.).
- The effective date, if passed, would be the date of enactment.

Continued on next page

Legislation, Continued

H.R. 586, Tax Relief Guarantee Act of 2002 (May 3, 2002)

Provisions - Sections 101, 251, 252, and 255:

- **Section 101** of the Act would repeal Title 9 of the Economic Growth and Tax Relief and Recovery Act of 2001.
  - A byproduct of this section 101 is that the sunset provisions that amended IRC 529 would be repealed.
  - The effective date is the date of enactment.
- **Section 251** of the Act would amend IRC 7611 (concerning church examinations) to remove from the IRC 7611 protections, information provided by the Secretary related to the standards for exemption from tax under this title and the requirements under this title relating to unrelated business taxable income.
  - The effective date is the date of enactment.
- **Section 252** would amend IRC 7428 to extend the declaratory judgment procedures to all IRC 501(c) organizations. It would also alter the list of federal courts that have jurisdiction to hear IRC 7428 cases.
  - Effective date: This provision would apply to pleadings filed with respect to determinations (or requests for determinations) made after the date of enactment.
- **Section 255** would require annual reports be submitted to TIGTA concerning the abatement of penalties. The effective date is the date of enactment.